



June 26, 2003

Mr. Leo Memmott  
Olympic Officer / Advisor  
State of Utah  
124 State Capitol  
Salt Lake City, Utah 84114

**RE: Policyholder Benefit from WCF's Historical Federal Tax Exemption**

Dear Mr. Memmott:

This letter addresses the additional question posed by the State of Utah (the State) regarding the value of the collective benefit to policyholders resulting from the Workers Compensation Fund's (WCF or the Company) historical Federal tax exemption. In Section V ("General Concepts of Value") of D&T's Report on the Privatization Options for WCF, we discussed the effect of the Federal tax exemption on only WCF's surplus and not specifically of the potential benefits to WCF's policyholders.

D&T believes that WCF's historical exemption from Federal income tax may have provided significant benefit to the policyholders. However, it is difficult to precisely quantify this benefit for many different reasons. For instance, WCF management may have implemented different strategies for the Company if WCF was a tax-paying entity. Examples of potential different strategies include the following:

1. Change the asset portfolio so that some, or all, of its investments were tax-exempt.
2. Implement a different underwriting policy.
3. Utilize a different pricing strategy.
4. Adjust the policyholder dividend philosophy.
5. Do not insure the residual market.

In addition, the tax position of the policyholders and changes in the insurance tax law over time add to the uncertainty in quantifying the benefit of the Federal tax exempt status.

This above discussion is not intended to be all-inclusive, but it provides several examples of factors that could have a significant impact on measuring the value of the tax exemption to the policyholders. In many cases, in the alternative where the WCF is a taxable entity, certain management decisions most likely would have been made to mitigate the effect of not having a Federal tax exemption.

For purposes of responding to the State's question, one might use the estimated Federal income taxes that the WCF would have paid as a potential proxy. However, we note that this proxy does not consider the different factors discussed above. This approach would compute an estimate based on the tax liability the WCF would have incurred if it were a taxpaying entity using historical financial information and an assumed Federal income tax rate of 35%.

An estimate of the cumulative tax liability under this approach is calculated on Exhibit 1. The proxies for the annual Federal income tax liabilities are calculated for calendar years 1995 through 2002. Due to the lack of detailed financial information for periods before 1995<sup>1</sup>, we estimated taxable income for all periods prior to 1995 to be equal to statutory surplus. It is important to note that this estimate could fluctuate for both changes in tax law and book tax differences for pre-1995 tax years.

Using this approach, we have estimated the historical tax liability to be \$98.4 million which represents our estimate of the upper bound of the value of the benefit of the Federal tax exemption to policyholders. However, as noted above, it is difficult to know to what extent management would have pursued tax management strategies which might have offset the value of the benefit. Therefore, we cannot estimate what a minimum value of the benefit would have been.

### **Caveats and Limitations**

We note that the Caveats and Limitations and the Distribution and Use comments included in the Introduction Section of our report of June 16, 2003 are included herein by reference.

In particular, we emphasize that this letter is not providing, nor is it responsible for providing tax or legal advice hereunder.

Sincerely,

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Principal  
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Senior Manager  
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<sup>1</sup> The WCF began creating statutory financial statements in 1994.

# Workers Compensation Fund

## FEDERAL INCOME TAX - Historical Value

Corporate Tax Rate	35.0%
Alternative Minimum Tax Rate	20.0%

Tax Liability Calculations	1994	1995	1996	1997	1998	1999	2000	2001	2002
<b>Regular Taxable Income</b>									
Statutory Income Before PHD & FIT		51,514,779	55,348,862	104,432,300	39,233,779	27,127,223	20,153,651	9,833,987	(24,107,243)
Loss & LAE Reserve	360,195,000	403,470,000	452,060,301	452,060,301	442,250,752	439,064,621	453,482,108	489,803,000	548,958,161
Discount Factor	0.780	0.780	0.780	0.780	0.780	0.780	0.780	0.780	0.780
Discounted Loss & LAE Reserve	280,952,100	314,706,600	352,607,035	352,607,035	344,955,587	342,470,404	353,716,044	382,046,340	428,187,366
Change in Discount		9,520,500	10,689,866	0	(2,158,101)	(700,949)	3,171,847	7,990,596	13,014,135
Unearned Premium Reserve	2,069,425	2,429,522	6,084,603	6,764,277	11,030,459	17,196,418	24,296,781	28,363,063	37,311,941
Customer Deposits	33,011,385	33,698,928	25,735,253	19,580,884	15,370,792	9,120,423	2,074,421	1,615,706	424,263
Revenue Offset		209,528	(861,719)	(1,094,939)	11,218	(16,882)	10,872	721,513	1,551,487
Tax-Exempt Investment Income		0	0	0	0	0	0	0	0
Equity Dividends Received		1,649,615	1,906,429	586,872	471,630	199,072	131,709	676,320	1,510,681
Dividends Received Deduction		1,154,731	1,334,500	410,810	330,141	139,350	92,196	473,424	1,057,477
Proration of Tax-Exempt Income		173,210	200,175	61,622	49,521	20,903	13,829	71,014	158,621
Meals & Entertainment		197,104	241,000	77,480	80,680	86,447	93,443	120,225	100,734
Meals & Entertainment Disallowance		98,552	120,500	38,740	40,340	43,224	46,722	60,113	50,367
Regular Taxable Income Before PHD		60,361,838	64,163,184	103,026,912	36,846,616	26,334,168	23,304,725	18,203,799	(10,390,109)
Policyholder Dividends		8,704,108	30,939,723	17,149,437	39,800,311	25,500,000	5,950,800	8,000,000	2,441,504
Regular Taxable Income		51,657,730	33,223,461	85,877,475	(2,953,695)	834,168	17,353,925	10,203,799	(12,831,613)
Regular Taxable Income after NOL carryovers		51,657,730	33,223,461	85,877,475	(2,953,695)	0	2,402,785	10,203,799	(12,831,613)
Regular Federal Income Tax		18,080,206	11,628,211	30,057,116	(1,033,793)	0	840,975	3,571,330	(4,491,064)
<b>Alternative Minimum Tax</b>									
ACE Adjustment		736,141	850,744	261,892	210,465	88,836	58,775	301,808	674,141
Alternative Minimum Taxable Income		52,393,871	34,074,205	86,139,367	(2,743,230)	923,004	17,412,700	10,505,607	(12,157,471)
AMT Taxable Income after NOL carryovers		52,393,871	34,074,205	86,139,367	(2,743,230)	92,300	3,342,702	10,505,607	(1,215,747)
Alternative Minimum Federal Income Tax		10,478,774	6,814,841	17,227,873	(548,646)	18,460	668,540	2,101,121	(243,149)
<b>Carryovers</b>									
End of Year Regular Carryover					(2,953,695)	(2,119,527)	0		
End of Year AMT Carryover					(2,743,230)	(1,912,526)	0		
Carryback from 2002 Regular							(12,831,613)		
Carryback from 2002 AMT							(12,157,471)		
<b>Federal Income Tax Due</b>		18,080,206	11,628,211	30,057,116	0	18,460	840,975	3,571,330	0

<b>Value of Federal Tax Exemption</b>		
Tax Incurred 1995 - 2002 (a)		64,196,298
Statutory Surplus 12/31/94 (b)		97,730,993
Value of Federal Tax Exemption = (a) + 35% x (b)		<b>98,402,145</b>